In depth
A look at current financial reporting issues

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What's inside:

Accounting implications of UK's Brexit decision Volume 1

At a glance

The UK has voted to leave the EU, which might impact the financial results and position of UK companies and of many multinationals doing business with the UK. There is likely to be a protracted period of negotiation, so our guidance in this 'In depth' is focused only on the immediate impact of the decision. It is Volume 1 of an expected series of guidance on the financial reporting consequences of Brexit. This In depth will be particularly relevant to those entities with a 30 June 2016 year end and those finalising interim reports.

The biggest accounting impact for 30 June reporting will be disclosure updates to explain judgements and risks. Valuations, measurements and impairment calculations that use market inputs should be updated to use market data at 30 June 2016. There might be further measurement issues to consider in the medium term. Entities might consider reorganising or restructuring their business based on the leave vote. Contemplated reorganisation or restructuring is unlikely to have an immediate impact on the financial statements at 30 June 2016. However, such plans over time could result in the impairment/disposals of assets, recognition of provisions, changes to segments and further disclosure.

We will continue to update our financial reporting guidance under IFRS as the full impact of Brexit develops.

General Disclosures

Are additional disclosures required?

Relevant guidance

- IAS 34 and IAS 1
- Disclosure requirements

Accounting implications

- Critical judgements, sensitivities and risk exposures might have been significantly impacted by the potential economic consequences of Brexit.
- The extent of disclosures regarding estimation uncertainty might need to be increased. For example, if more items are now subject to a significant risk that the carrying amount might change materially within the next year.

- The disclosures regarding risks and uncertainties should include commentary on the potential impact of Brexit. The full impact might not yet be clear, so this analysis might be at a relatively high level.
- Management should assess the entity's ability to continue as a going concern. Cash flow forecasts might need to be updated to reflect the potential impact of the referendum. Uncertainties over going concern should be disclosed.
- Post balance sheet events (such as large changes in asset values and significant movement in exchange rates) should be considered for disclosure as non-adjusting events.

Interim reporting

- Entities need to consider the extent to which additional disclosures are necessary in the interim report, to explain changes since the last annual report.
- An entity is required to disclose "changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities whether these are measured at amortised cost or fair value."

Operational implications

- Review specific contract terms impacted or potentially impacted by Brexit, including possible termination clauses.
- Assess covenants' terms to identify any breaches as a result of changes in the value of assets and liabilities.

Risk disclosures (annual financial statements only)

Are additional risk disclosures required?

Relevant guidance

- IFRS 7
- Disclose exposure to risk, including: how it arises, management's objectives, policies and processes for managing the risk and the methods used to measure the risk.
- Specific quantitative disclosures required about market risk, credit risk and liquidity risk. These include sensitivity analysis for market risk (*currency risk*, *interest rate risk*, *other price risk*).

Accounting implications

Credit risk

- There might be a change in credit risk on an entity's financial assets. The change in credit risk and management's activities to react to these changes should be disclosed.
- There might also be significant financial difficulties for entities that are engaged in certain industries (for example the travel industry). Credit quality, amounts past due and impairment provisions might change for loans and receivables from these entities.
- The fair value of properties and other non-financial assets pledged as collateral might also be affected.

Liquidity risk

- Entities need to assess whether Brexit results in a change in liquidity risk. Any change, as well as management's activities in order to react to these changes, should be disclosed.

- An entity might encounter difficulties in obtaining sufficient funding and meeting its obligations under existing financial liabilities. The risk of breaching loan agreement terms (covenants) might increase.
- The liquidity or value of assets held to manage liquidity risk might decrease.

Currency risk

- There has been a devaluation of Sterling and an immediate period of exchange rate volatility. Depending on future developments exchange rates for GBP might remain more volatile.
- Entities with a functional currency other than GBP that have investments in financial instruments denominated in GBP should consider additional disclosures on how they react to increasing volatility in exchange rates.
- Entities should consider whether the range of reasonably possible changes in GBP exchange rates used for the sensitivity analysis should be revised.

Other price risks

- There has been increased volatility on stock markets following the referendum. An entity that has investments in listed securities needs to assess whether the increase in volatility results in a change in its exposure to *other price risk* and whether the sensitivity analysis needs to be updated.

Operational implications

- Analyse risk management in the light of the changes in the economic environment and assess to what extent adjustments are necessary.
- Gather the relevant information to meet the disclosure requirements in IFRS 7. This is the case, in particular, if there are investments denominated in GBP or in industries/territories that are economically impacted by Brexit
- Assess whether the economic developments will impact the entity's ability to obtain funding.
- Assess which changes in foreign exchange rates and other relevant prices are regarded as 'reasonably possible'.

Impairment and valuation

Impairment – Non financial assets

Is there an impairment indicator? Do impairment models change?

Relevant guidance

- IAS 36 and IFRS 13
- An impairment review should be performed if there is an indicator of impairment. For example, a change in circumstances in the period with a potential adverse effect on the entity.
- An asset's/CGU's value should reflect an estimate of the future cash flows that the entity expects to derive from the asset/CGU at the date of the impairment test.
- Extensive disclosure requirements exist where impairment losses are recognised and when headroom is small.

Accounting implications

- An entity should consider whether the consequences of Brexit have an adverse impact on its cash flows and trigger an impairment test. Annual tests of goodwill and indefinite lived intangibles carried out before June 2016 may need updating for year end reporting.
- Volatile share prices might drive market capitalisation below net asset value and trigger an impairment test.

- Increased risk and uncertainty should be factored into the impairment test. Budgets and forecasts used to determine the recoverable amount will need to be revised to reflect the economic conditions at 30 June 2016.
- The expected cash flow approach (multiple probability-weighted scenarios) in estimating the recoverable amounts might be more appropriate than the traditional approach (single predicted outcome) considering the increased risk and uncertainty. There might be a range of potential outcomes considering the best and worst case scenarios. A range of scenarios might be needed where entities import or export to or from the UK, to reflect the different trade agreements that could be signed.
- The discount rate might also need to be updated to reflect additional risks that have not been included in the cash flows. The UK country risk used in discount rates might need to be revised.
- Future cash flows are estimated in the currency in which they arise using a discount rate in that currency. The present value is then discounted using a spot rate at the date of the ViU calculation (i.e. the spot rate at 30 June 2016).

Operational implications

- Monitor carefully the impact of Brexit and of decisions that might be taken going forward, on interest rates, country risk profiles and impact in the cash flows as a result of the various scenarios.
- Export and import profiles and cost bases might change and, if they do, cash flow models will need to be updated.
- Consider industry outlooks as information becomes available when adjusting for future cash flows.
- Consider using more sophisticated cash flow models to project different outcomes and to ensure all risk is adequately included.

Recoverability of Deferred Tax Assets

Are deferred tax assets recoverable?

Relevant guidance

- IAS 12
- Deferred tax assets can only be recognised to the extent that it is probable that taxable profits will be available in the future to utilise temporary differences and tax loss carry forwards.

Accounting implications

- Budgets and forecasts of future taxable profits used to assess the recoverability of deferred tax assets might need to be revisited to reflect increased risk and uncertainty.
- Deferred tax assets that are no longer recoverable would need to be written off.

Operational implications

- Assess the impact of increased uncertainty on budgets and forecasts to consider whether deferred tax assets are recoverable.

Valuation – Non-financial assets

Is the value of non-financial assets impacted?

Relevant guidance

- IAS 2, IAS 16, IAS 40, IFRS 10, IAS 28, IFRS 13

Inventories

- Inventories are measured at the lower of cost and net realisable value.

Investment property and property plant and equipment

- Investment property and property plant and equipment (PPE) measured under fair value models are revalued at the end of the reporting period.

Subsidiaries, associates and joint ventures measured at fair value

- Equity investments in subsidiaries might be carried at fair value under the investment entity exemption in IFRS 10. Investments in associates and joint ventures might be carried at fair value when held by venture capital organisations, mutual funds or similar entities under the exemption in IAS 28.

Accounting implications

Inventories

- It might be necessary to write-down inventories to net realisable value.
- Entities with property under development classified as inventory could be impacted by a fall in housing prices.

Investment properties and property, plant and equipment

- There might be greater volatility in the fair values of PPE following the UK referendum. A revaluation should be performed at 30 June 2016 if the carrying amount is likely to be materially different from the fair value.
- Investment properties should be measured at fair value at 30 June 2016. An entity should maximise the use of market data, where available, at that date.
- More assets might fall into the Level 3 measurement category if the market becomes less liquid.
- Inputs and models used to measure fair value under level 3 might need to be updated.
- The requirement to disclose "reasonably possible alternative assumptions" under IFRS 13 might be triggered and the disclosures required by IFRS 13, particularly for Level 3 measurements, will need to be updated.

Subsidiaries, associates and joint ventures measured at fair value

- Fair values of investment entities as well as associates and joint ventures measured at fair value might be impacted by equity market volatility.
- The starting point for valuations of listed companies should be the market prices as at 30 June for the number of shares held.
- Small adjustments to the price used to measure fair value might be appropriate for control premiums. Adjustments should be supportable and disclosed and could attract regulator attention. No adjustments should be made for anticipated price rises.
- Entities are required to disclose changes in business or economic circumstances that affect the fair value of investment entities or investments in associates and joint ventures carried at fair value under IFRS 9/ IAS 39.

Operational implications

- Independent valuations for property classified as inventory, investment property and property, plant and equipment might be needed at 30 June 2016.
- Assess real estate prices and indices to determine if any changes are needed.

Impairment of financial assets

Should financial assets be tested for impairment?

Relevant guidance

- IAS 39
- At the end of every reporting period an entity shall assess whether there is any objective evidence that a financial asset is impaired.
- A significant or prolonged decline in an equity instrument's fair value below its cost is evidence of impairment.
- The calculation of the amount of any impairment loss on a collateralised financial asset takes into account the net cash flows that might result from foreclosure.

Accounting implications

Events that indicate an impairment include:

- Significant financial difficulties of the issuer or obligor.
- Probable that the borrower will enter bankruptcy or other financial reorganisation, and
- Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets. For example, national or local economic conditions that correlate with defaults on the assets in the group (such as an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

If there is objective evidence that an impairment loss has been incurred, the amount of loss is calculated as follows:

- <u>Financial assets carried at amortised cost:</u> Difference between the carrying amount and the present value of estimated future cash flows discounted at the original effective interest rate.

- <u>Financial asset carried at cost:</u> Difference between the carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

- <u>Available-for-sale assets:</u> Difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value less any impairment loss previously recognised in profit or loss.

Debt instruments

- Loans and receivables with entities in industries potentially impacted by Brexit need to consider the extent to which:
    - financial difficulties of customers qualify as a loss event and hence trigger an impairment loss;
    - the general change in the economic environment and the increasing uncertainty as a result of Brexit results in a measureable decrease in estimated future cash flows from a group of loans; and
    - the fair value of any non-financial assets (for example properties) pledged as collateral has declined.

Equity instruments

- The volatility on stock markets has increased. An entity that has significant investments in listed equity instruments needs to assess whether a decrease in share price qualifies as a 'significant decline in fair value'. It is important to note that a significant decline in fair value triggers an impairment even if it is not prolonged.
- As there is no explicit guidance in the standard on what is meant by a 'significant decline in fair value' an entity needs to establish an accounting policy. Once

developed, a policy has to be applied consistently; current market developments do not justify a change in an existing accounting policy.

Operational implications

- Gather relevant data to assess whether loans and receivables provided to customers that are affected by Brexit need to be impaired.
- A revised valuation for a collateralised loan might be necessary.

Valuation- Financial instruments

Does the valuation of financial instruments change?

Relevant guidance

- IFRS 13, IAS 39
- Most financial instruments are measured at fair value at initial recognition.
- Financial instruments at fair value through profit or loss and financial assets classified as available for sale are also measured at fair value in subsequent periods.
- The fair value of financial instruments can be determined either based on market prices (market approach) or based on another valuation technique (for example, present value techniques or option price models).

Accounting implications

- The volatility of prices on various markets has increased since Brexit. This impacts the fair value measurement either directly - if fair value is determined based on market prices (for example, in case of shares or debt securities traded on an active market) or indirectly - if the valuation technique is based on inputs that are derived from volatile markets.
- Counterparty credit risk and the credit spread that is included in a fair value measurement might increase if the counterparty is engaged in industries/territories that are potentially affected by Brexit.
- The change in the fair value measurement affects the disclosures required by IFRS 13. The sensitivity analysis required for recurring fair value measurements categorised within level 3 of the fair value hierarchy might be affected.
- An entity has to provide several disclosures on the valuation techniques and the inputs used in the fair value measurement. Most of them are required in annual and interim financial statements.

Operational implications

- Consider whether the inputs used in the fair value measurement need to be updated.

Foreign exchange rates

Which foreign exchange rate should be used?

Relevant guidance

- IAS 21
- Foreign currency monetary items outstanding at the balance sheet date should be translated at the closing rate, i.e. 30 June 2016.
- A foreign currency transaction shall be recorded using the spot rate at the date of transaction.

Accounting implications

- An average rate that approximates the actual rate at the date of transaction can be used for practical reasons. However, the use of an average rate is not appropriate if exchange rates fluctuate significantly.
- The length of the period over which average rates are calculated (monthly, quarterly etc.) depends on the extent to which daily exchange rates fluctuate in the period selected. The more stable a rate is the longer the period can be over which the average rate is calculated.
- Brexit has resulted in a devaluation of Sterling. Exchange rates for GBP are expected to be more volatile depending on future developments. The use of an average rate may no longer be appropriate. An entity should also consider the period over which the average rate is calculated.

Operational implications

- Systems and processes might need to be updated to capture the new exchange rates.

Hedge accounting

Is hedge accounting impacted?

Relevant guidance

- IAS 39
- A forecast transaction needs to be highly probable to qualify as an eligible hedged item in a cash flow hedge.
- Hedge accounting can be applied only if the hedge is highly effective.

Accounting implications

- The realisation/timing of forecast transactions might change. For example, the timing and/or amount of future revenues or the timing of a planned bond issue might change as a consequence of current uncertainty.
- An entity that has designated a forecast transaction as a hedged item needs to assess whether the transaction is still highly probable of occurring.
- A change in the timing of a forecast transaction can result in ineffectiveness.
- If a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss.

- Where there are differences between the critical terms of the hedging instrument and the hedged item, the volatility following Brexit might result in additional ineffectiveness. Examples include where there are differences in the timings (e.g. reset dates on floating rate borrowings and swaps used to hedge) or in the underlying hedged risks. If this additional ineffectiveness results in the hedge no longer being highly effective, hedge accounting must be discontinued. Changes in the credit risk of the derivative financial instrument designated as hedging instrument might also result in additional ineffectiveness.

Operational implications

- Assess to what extent the current economic developments change management's intention and/or ability to realise forecast transactions.
- Assess the impact of any additional ineffectiveness arising from Brexit.
- Undertake general risk assessment and consider new hedging contracts to minimise additional risk.

IFRS 9 - Impairment of financial assets

Does Brexit impact IFRS 9?

Relevant guidance

- IAS 8, IFRS 9
- An entity recognises a loss allowance for expected credit losses on a financial asset.
- A lifetime expected credit loss is used where credit risk on a financial asset has increased significantly since initial recognition.

Accounting implications

- Brexit might result in significant financial difficulties for entities that are engaged in certain industries/territories.
- An entity that has early adopted IFRS 9 or is considering adopting would need to measure impairment based on expected credit losses. This is a different model to IAS 39.
- IFRS 9 requires that forward-looking information (including macro-economic information) is considered both when assessing whether there has been a significant increase in credit risk and when measuring expected credit losses.
- For any financial assets that are in the scope of the IFRS 9 impairment requirements (for example loans and receivables, debt instruments not measured at fair value through profit or loss, or lease receivables) an entity should consider whether:
    - the credit risk (risk of default) has increased significantly; and
    - the loss as a result of default has increased due to a decrease in the fair value of a non-financial asset pledged as collateral.
- IAS 8 requires disclosure of the impact of new accounting standards. The impact of IFRS 9 might need to be reconsidered in light of Brexit.

Operational implications

- Gather relevant data (including forward-looking macro-economic information) to be able to assess whether there is a significant increase in credit risk and to what extent the 12-month, or lifetime expected credit losses, have changed.
- A revised valuation for a collateralised loan might be necessary.

Restructuring and Personnel

Are additional provisions needed? Are pensions and share-based payments impacted?
Relevant guidance
• IAS 37, IAS 19, IFRS 2 • An entity must reassess the expected outcomes for provisioning. Provisions should be based on best estimates of the future cash flows and other relevant assumptions. • Plan assets are measured at fair value for a defined benefit pension plan. • IFRS 2 requires changes in expectations regarding non market-based vesting conditions to be reflected at each reporting date.
Accounting implications

• The relevant standards require estimates of provisions to be updated at each balance sheet date based on expectations and market conditions.
• Restructuring provisions are recognised when there is a present obligation. A present obligation exists only when an entity has a detailed formal plan and has raised valid expectations about those plans, which typically follows an announcement of the intention to restructure. It is unlikely that the recognition criteria would be met for any restructuring that is being contemplated as a result of the outcome of the UK referendum prior to the i.
• Existing provisions, including employee benefits and cash-settled share-based payments should be reviewed to:
  o Update discount rates for market movements;
  o Update expected cash flows for changes in assumptions as a result of the outcome of the UK referendum, including the impact of exchange rate volatility and possible changes in inflation expectations.
• The fair value of plan assets for defined-benefit pensions should be updated to reflect market prices at 30 June 2016.
• The expectations for the outcome of performance conditions on share-based payments should be updated.
• The range of reasonably possible changes to be considered in sensitivity analyses might have increased, in particular foreign exchange and interest rates.

Operational implications
• Continue to assess the impact of changes on provisioning and monitor any restructuring plans to identify if, and when, a provision should be recognised. • Review share-based payment contracts to assess any changes to non market-based vesting conditions. • A revised valuation of plan assets might be required. • Develop appropriate sensitivity analyses.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

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